

DOCUMENTS CROSS-REFERENCE

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EXECUTIVE SECRETARIAT

## ROUTING SLIP

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1	DCI				
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3	EXDIR				
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10	GC				
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13	D/OLL				
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15	D/PERS				
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17	NIO/ECON		X		
18	D/OGI		X		
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Remarks

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Executive Secretary

9 Dec 85

Date

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Executive Registry

4312/1

**THE WHITE HOUSE  
WASHINGTON**

**CABINET AFFAIRS STAFFING MEMORANDUM**

**Date:** 12/5/85      **Number:** 317034CA      **Due By:** \_\_\_\_\_  
**Subject:** Cabinet Council Minutes

ALL CABINET MEMBERS	Action	FYI		Action	FYI
Vice President	<input type="checkbox"/>	<input checked="" type="checkbox"/>	CEA	<input type="checkbox"/>	<input checked="" type="checkbox"/>
State	<input type="checkbox"/>	<input checked="" type="checkbox"/>	CEQ	<input type="checkbox"/>	<input type="checkbox"/>
Treasury	<input type="checkbox"/>	<input checked="" type="checkbox"/>	OSTP	<input type="checkbox"/>	<input type="checkbox"/>
Defense	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Justice	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Interior	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Agriculture	<input type="checkbox"/>	<input checked="" type="checkbox"/>			
Commerce	<input type="checkbox"/>	<input checked="" type="checkbox"/>	McFarlane	<input type="checkbox"/>	<input checked="" type="checkbox"/>
Labor	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Svahn	<input type="checkbox"/>	<input checked="" type="checkbox"/>
HHS	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Chew (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HUD	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Transportation	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Energy	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Chief of Staff	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Education	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
OMB	<input type="checkbox"/>	<input checked="" type="checkbox"/>			
CIA	<input type="checkbox"/>	<input checked="" type="checkbox"/>	Executive Secretary for:		
UN	<input type="checkbox"/>	<input checked="" type="checkbox"/>	DPC	<input type="checkbox"/>	<input checked="" type="checkbox"/>
USTR	<input type="checkbox"/>	<input checked="" type="checkbox"/>	EPC	<input type="checkbox"/>	<input checked="" type="checkbox"/>
GSA	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
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**REMARKS:**

Attached for your information are the minutes of the following Economic Policy Council Meetings:

November 4, 1985  
 November 5, 1985  
 November 7, 1985

**RETURN TO:**

☒ Alfred H. Kingon  
 Cabinet Secretary  
 456-2823  
 (Ground Floor, West Wing)

☐ Don Clarey  
☐ Rick Davis  
☐ Ed Stucky

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 EXEC  
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L-300B

MINUTES  
ECONOMIC POLICY COUNCIL

November 4, 1985  
2:00 p.m.  
Cabinet Room

Attendees: The President, Messrs: Baker, Block, Hodel, Baldrige, Brock, Herrington, Regan, Miller, Yeutter, Sprinkel, Whitehead, Darman, Jensen, Kingon, McAllister, Daniels, Ogelsby, Svahn, Thomas, Chew, Dawson, Khedouri, Naylor, Sethness, and Stucky, and Ms. Dole.

1. Farm Credit System

Secretary Baker stated that the purpose of the meeting was to review the financial status of the Farm Credit System (FCS) and the legislative outlook in Congress. He noted that the Economic Policy Council devoted a great deal of attention to the issue of the Farm Credit System, meeting several times on the issue in recent weeks. In addition, he told the President that the Council met with representatives of the FCS and the Farm Credit Administration (FCA) to convey the Administration's concern with the System's problems and willingness to help them solve their problems.

Secretary Baker reiterated the President's previous decision that the Administration in testimony regarding the FCS should express our support for the following:

1. Restructuring the FCA into a true regulator;
2. Creating authorities for the Farm Credit System Capital Corporation (FCSCC) to fully mobilize within the system the FCS's earned surplus to absorb operating losses and manage troubled loan assets;
3. Assessing the need for Federal financial assistance, provided Congress enacts legislation achieving the regulatory and operating reforms outlined above.

Mr. Naylor stated that the poor condition of the Farm Credit System is indicative of the condition of the farm sector in general, with the Corn and Grain Belts in particular experiencing significant declines in land values. According to Mr. Naylor, the number of farmers affected by these declines also has been significant -- nearly 10 percent of farmers are in a highly leveraged position. He noted that the volume of loans made by

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Economic Policy Council  
November 4, 1985  
Page two

the Farm Credit System has grown substantially since 1976, particularly in terms of short-term credit outstanding. For example, he pointed out that one-half of outstanding loans of the Omaha District bank, which is in serious trouble, were made over the period 1979-81. Other district banks that are experiencing or will experience difficulties include St. Paul, Wichita, and Louisville.

Mr. Naylor explained that rapid growth of the Farm Credit System has created managerial problems. He reported that the FCS has undertaken an internal financial assessment of its condition headed by the accounting firm of Price Waterhouse. According to Mr. Naylor, under reasonable assumptions the FCS can expect \$6 billion in losses over the next three years. In addition, he noted that of the FCS's \$74 billion portfolio, \$13 billion represent bad loans. However, he said, the FCS has accumulated a strong balance sheet including substantial earned surplus and capital of roughly \$12 billion.

Mr. Naylor stated that the Economic Policy Council believes the FCS can solve its own problems, provided it maintains access to the financial markets. He stated that the Economic Policy Council reached the following conclusions regarding the FCS:

1. Inadequate regulation has contributed to the problems of the FCS. The FCA lacks the authority and enforcement powers necessary for effective oversight.
2. Lack of centralization within the System prevents the pooling of financial and managerial resources. The Council has agreed that legislative changes are necessary to permit the mobilization of the FCS's resources.

Mr. Naylor reiterated that the Administration has agreed to assess whether some form of Federal financial assistance is necessary but only after regulatory restructuring of the FCA and consolidation of the FCS's resources. He stated that Congress appears willing to move legislation resolving the FCS's difficulties on a fast track and that legislation affecting the FCS may be approved before the end of the year.

Secretary Block pointed out that the FCS provides one-third of the nation's farm credit. As the System absorbs bad loans, he said, it must raise rates on other loans, placing a greater burden on farmers. He suggested that it is critical that the FCS be able to borrow in the markets at reasonable rates which can be passed along to farmers.

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Economic Policy Council  
November 4, 1985  
Page three

Mr. Whitehead agreed that the critical issue is the FCS's ability to continue borrowing in the markets. Secretary Baker suggested that requiring creditors to absorb loan losses would make it extremely difficult to issue new FCS securities.

Mr. Regan noted that the FCS is a private institution, similar to Chrysler and Continental Illinois. He suggested that Federal financial assistance would serve to protect the FCS's creditors and is not a Federal responsibility.

Dr. Sprinkel stated that Federal financial assistance to the FCS would create the wrong incentives. For example, he said, holding out the possibility of Federal assistance would create an incentive for the FCS to dissipate its assets and would encourage agricultural banks and other financial institutions, including LDC lenders, to seek Federal assistance. He stated that the current status of the FCS is symptomatic of a fundamental problem in the agricultural sector.

Ambassador Yeutter cautioned that if the farm credit problem is not solved this year, Congress will take it up in the more emotional atmosphere of the spring planting period. He suggested the timing is critical to the legislative strategy.

#### Steel and Citrus-Pasta Negotiations

Ambassador Yeutter stated that the United States and the Economic Community (EC) have tentatively agreed on an extension of the Steel Arrangement that would lower shipments from the EC by twenty percent below 1985 levels. He cautioned, however, that the British may veto the Arrangement as it would preclude their shipping of semifinished steel into a new steel plant in Tuscoloosa, which is owned in part by British interests.

Ambassador Yeutter stated that an October 31 deadline chosen by the EC for a citrus-pasta resolution has passed without an agreement. The EC did not make an offer until October 31 and that the offer was inadequate to the United States. He explained that the United States has retaliated against pasta imports, as we stated we would, and the EC has countered by imposing tariffs on walnuts and lemons. According to Ambassador Yeutter the U.S. will resume negotiations on the citrus-pasta issue within the next two weeks.

MINUTES  
ECONOMIC POLICY COUNCIL

November 5, 1985  
1:00 p.m.  
Roosevelt Room

Attendees: Messrs. Baker, Block, Baldrige, Brock, Herrington, Miller, Yeutter, Sprinkel, Darman, Taft, Jensen, Svahn, Kingon, McAllister, Danzansky, Hoffman, McMinn, Poindexter, Smart, Smith, and Ms. Risque.

1. Report of the Strike Force

Mr. Smart stated that the Strike Force on trade was presenting its recommendations on semiconductors and intellectual property for review by the Economic Policy Council. The Strike Force considered several factors in developing its recommendations including the impact of the unfair trade practice. Mr. Smart briefly reviewed the significance of trade in semiconductors and their critical importance to technological development.

He stated that the U.S. share of the Japanese market is roughly 10-14 percent, and has been so for some time. He stated that Japan has restricted imports of U.S. semiconductor products, while targeting its own semiconductor industry. He suggested that Japan has overinvested in semiconductor production, and products are now being dumped in U.S. markets for less than the cost of production.

He reviewed the three recommendations developed by the Strike Force:

1. Prompt investigation and resolution of the two existing dumping cases. Self-initiation by the Department of Commerce of an antidumping case on 256K RAMs.
2. Support of USTR's accelerated plan for handling the existing 301 case. Support for consideration of a package proposal (addressing both market access and dumping) on semiconductors if the Japanese propose one.
3. Announcement that the President will consider other remedial and/or preemptive actions to ensure U.S. access to Japanese markets.

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November 5, 1985  
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Secretary Baldrige emphasized the importance of semiconductors to technology and technological growth. He argued that if the U.S. loses its semiconductor capacity, prospects for future technological development will be damaged. He expressed his support for the recommendations, noting that the Department of Commerce believes it can present a good case that dumping exists.

Ambassador Yeutter stated that the dumping case would be helpful in satisfactorily resolving the Section 301 case initiated by the Semiconductor Industry Association. He expressed some caution about self-initiating an antidumping case, noting that the industry has not argued for such a case. Mr. Smart suggested that the industry has not filed an antidumping case because it is vulnerable to retaliation by the Japanese Government.

The Council discussed a number of issues, including whether the 256K RAM case is a good antidumping case. The Council agreed that the Administration should only initiate antidumping cases against Japanese 256K RAMs if the Department of Commerce is strongly convinced that the dumping exists and the International Trade Commission (ITC) will find injury. The Council also discussed the consequences of a successful antidumping case. The price of imported semiconductors would increase, but because semiconductors are a relatively inexpensive component of products such as computers and automobiles, the impact on prices of final goods generally would not be significant.

The Council also discussed Japanese industrial practices in general and the importance of increasing U.S. competitiveness and productivity through better government policy. Mr. Taft noted that the U.S. is subsidizing our semiconductor industry. Ambassador Yeutter noted that these subsidies are GATT-legal, unlike the dumping practices which the Japanese are alleged to pursue.

The Council discussed at some length recommendation three: to announce that the President will consider other remedial or preemptive actions to ensure U.S. access to Japanese markets. Secretary Baldrige suggested that such a step was necessary to emphasize to the Japanese the Administration's intent on achieving a settlement of the Section 301 cases and the dumping and predatory pricing issues. Several members of the Council expressed some skepticism about the implications of the recommendation. Other members, believing that recommendation three would result in a closing of our markets to critically



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November 5, 1985  
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needed high tech products, expressed opposition to the recommendation.

Decision

Secretary Baker asked Mr. McAllister to prepare a memorandum for the President reflecting each agency's views on the three recommendations.

MINUTES  
ECONOMIC POLICY COUNCIL

November 7, 1985  
1:00 p.m.  
Roosevelt Room

Attendees: Messrs. Baker, Block, Pierce, Miller, Darman, Whitfield, Burnley, Sprinkel, McAllister, Daniels, Johnson, Driggs, Danzansky, Khedouri, Hoffman, Ortner, Stucky, and Wallis, and Ms. Eickhoff, and Ms. Risque.

1. Economic Review

Mr. Johnson, Assistant Secretary of the Treasury, stated that the economy currently is growing at a faster pace than earlier in the year. He also suggested that there is a data lag, particularly with regard to imports, that may lead to our underestimating real growth. He noted that the current period compares well with past expansions and suggested that the economy is now entering a second phase of expansion, with increases in inventory investment and net exports. Other signs of accelerating growth include increasing employment, new orders, and purchases of capital goods. He suggested that housing starts are also likely to increase at a faster pace in the near term. He pointed out that the inflation rate has remained moderate, with the recent increase in wages reflecting increased productivity. Mr. Johnson also noted that the so-called risk premium, measured as the spread between AAA and BAA bonds, is narrowing and the stock market is reaching new highs.

Mr. Johnson stated that the national income GNP accounts will be rebased later this year, probably resulting in a larger estimate of real economic growth over the period 1972-84.

Ms. Eickhoff, Associate Director of the Office of Management and Budget, stated that fourth quarter growth will probably be quite strong. She explained that the good agricultural harvest could add as much as \$7 to \$10 billion to national output, or as much as two percentage points to real GNP growth. She suggested also that the introduction of a new IBM computer could also provide a substantial boost to growth. She stressed that the major impetus for further growth will be inventory accumulation. Ms. Eickhoff then briefly reviewed the dynamics of inventory accumulation and depletion.

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Dr. Sprinkel stated that money growth has grown very rapidly this year, raising concerns about future inflation. He pointed out that historically monetary velocity has been fairly predictable, causing a reliable relationship between M1 and inflation. He noted, however, that velocity has not increased since 1982, which is unusual. He suggested several reasons for the aberrant behavior of velocity: (1) volatile money growth over the past four years has led to volatile velocity; (2) financial institution deregulation has created new investment and savings instruments, which blur the lines between transactions accounts and savings accounts; (3) a decline in interest rates has made it less "costly" to hold money; and (4) a significant decline in inflationary expectations.

Dr. Sprinkel stated that the economy apparently can now absorb greater M1 growth, without generating inflation under the current circumstances. He cautioned, however, that in his opinion 13 percent growth in M1 is excessive, even with velocity growth of zero, and he suggested that the Federal Reserve should immediately begin to gradually reduce money growth. He observed that although there is no current evidence of reacceleration of inflation, the lag between money growth and inflation is roughly eighteen to twenty-four months.

The Council discussed whether a gradual reduction in M1 growth would affect real GNP growth in the fourth quarter. Dr. Sprinkel suggested it would not have an effect because of the lag between money growth and economy activity. Mr. Miller questioned the predictability of the lags in the relationships between M1-inflation and M1-real GNP. Mr. Johnson noted that relationship between M1 growth has been declining since August, and that the monetary base has not experienced acceleration similar to M1.

The Council also discussed the recent behavior of interest rates. Secretary Block suggested that short-term rates should not as high as they are, given the current relatively low inflation rate.

Dr. Sprinkel explained that, historically, the long-term real interest rate has been roughly 3 percent, while the short-term real rate has been 1 percent. He noted that it is difficult to properly estimate real interest rates because real rates are the difference between the nominal rates and inflationary expectations, not the current inflation rate. Ms. Eickhoff noted that the Gramm-Rudman Amendment could have some effect on long term expectations leading to lower real interest rates.

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The Council also briefly discussed possible future Federal Reserve's policy. Ms. Eickhoff noted that Federal Reserve Chairman Volcker has indicated that the Federal Reserve will not change policy. Dr. Sprinkel suggested that Chairman Volcker's statement might be interpreted as meaning that the Federal Reserve will not aggressively restrain M1 growth.

The Council also discussed the likelihood of a continued expansion. Dr. Sprinkel noted that the length of expansions are not preordained, but are the result of proper government policies. Mr. Wallis stated that the Administration has broken the pattern of inflation, which bodes well for a continued expansion. The Council strongly endorsed the importance of reducing the Federal budget deficit.

EXECUTIVE SECRETARIAT  
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SUSPENSE \_\_\_\_\_  
Date \_\_\_\_\_

Remarks

Executive Secretary  
4 NOV 85

Date

STAT

THE WHITE HOUSE  
WASHINGTON

Executive Registry
85- 4312

CABINET AFFAIRS STAFFING MEMORANDUM

Date: 11/1/85 Number: 317,016 Due By: \_\_\_\_\_  
Subject: Economic Policy Council Meeting with the President -- Monday,  
November 4, 2:00 P.M. -- Cabinet Room

ALL CABINET MEMBERS	Action	FYI		Action	FYI
Vice President	<input type="checkbox"/>	<input type="checkbox"/>	CEA	<input checked="" type="checkbox"/>	<input type="checkbox"/>
State	<input checked="" type="checkbox"/>	<input type="checkbox"/>	CEQ	<input type="checkbox"/>	<input type="checkbox"/>
Treasury	<input checked="" type="checkbox"/>	<input type="checkbox"/>	OSTP	<input type="checkbox"/>	<input type="checkbox"/>
Defense	<input type="checkbox"/>	<input checked="" type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
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Labor	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Chew (For WH Staffing)	<input checked="" type="checkbox"/>	<input type="checkbox"/>
HHS	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Hicks	<input type="checkbox"/>	<input checked="" type="checkbox"/>
HUD	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Transportation	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
Energy	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
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Education	<input checked="" type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
OMB	<input checked="" type="checkbox"/>	<input type="checkbox"/>	Executive Secretary for:	<input type="checkbox"/>	<input checked="" type="checkbox"/>
CIA	<input checked="" type="checkbox"/>	<input type="checkbox"/>	DPC	<input checked="" type="checkbox"/>	<input type="checkbox"/>
UN	<input checked="" type="checkbox"/>	<input type="checkbox"/>	EPC	<input type="checkbox"/>	<input type="checkbox"/>
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EPA	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>
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SBA	<input type="checkbox"/>	<input type="checkbox"/>	_____	<input type="checkbox"/>	<input type="checkbox"/>

REMARKS:  
The Economic Policy Council will meet Monday,  
November 4, at 2:00 P.M. in the Cabinet Room.  
The agenda and background paper are attached.

RETURN TO:

☒ Alfred H. Kington  
Cabinet Secretary  
456-2823  
(Ground Floor, West Wing)

☐ Don Cläre  
☐ Rick Davis  
☐ Ed Stucky



THE WHITE HOUSE  
WASHINGTON

November 1, 1985

MEMORANDUM FOR THE ECONOMIC POLICY COUNCIL

FROM: EUGENE J. McALLISTER *EM*

SUBJECT: Agenda and Paper for the November 4 Meeting

The agenda and paper for the November 4 meeting of the Economic Policy Council are attached. The meeting is scheduled for 2:00 p.m. in the Cabinet Room.

The single agenda item is the Farm Credit System (FCS). The Council will review the financial condition of the FCS and discuss the legislative actions necessary to strengthen the FCS.

Attachment

THE WHITE HOUSE  
WASHINGTON

ECONOMIC POLICY COUNCIL

November 4, 1985

2:00 p.m.

Cabinet Room

AGENDA

1. Farm Credit System



THE WHITE HOUSE

WASHINGTON

November 1, 1985

MEMORANDUM FOR THE PRESIDENT

FROM: THE ECONOMIC POLICY COUNCIL

SUBJECT: Farm Credit System

The Economic Policy Council has been following the difficulties of the Farm Credit System (FCS) very closely. The Council and its Working Group on Agricultural Credit Policy have been meeting with representatives of the FCS and the Farm Credit Administration (FCA), the Federal body which loosely regulates the FCS, to determine the scope of the FCS's problems, its capacity to absorb losses, and the package of restructuring initiatives necessary to help the FCS solve its own problems.

The Economic Policy Council has reached two conclusions:

1. The FCS is experiencing genuine financial difficulties and will report nearly \$6 billion in loan losses over the next three years.
2. The FCS, however, does appear to have sufficient earned surplus to absorb these losses without jeopardizing stock held by the borrowers (the farmers) if it is restructured to permit greater sharing of system-wide financial resources.

Earlier this week, the Council recommended to you several policies the Administration might pursue in testimony before Congress. You accepted those recommendations, and the Administration policy regarding the FCS and its difficulties is to:

1. Restructure the FCA into a true regulator;
2. Create authorities for the Farm Credit System Capital Corporation (FCSCC) to fully mobilize the FCS's earned surplus to absorb operating losses and to manage troubled loan assets; and
3. Assess the need for Federal financial assistance but only if Congress is willing to legislate the changes that will accomplish 1 and 2 above.

This memorandum is intended to convey to you in greater detail the Council's conclusions regarding the financial condition of the FCS and the specifics of the legislative changes that we seek for the FCA and the FCS.

SCOPE OF THE PROBLEM

- o FCA and FCS estimates regarding the size of their potential problems due to bad assets and the potential losses to the System are not unreasonable. The exact size and timing of losses is, however, tied somewhat to the future course of the economy and the farm sector.
- o The System will have to report substantial overall losses over the course of the next three years, representing approximately \$3 billion for 1985 and \$1.5 billion in each of 1986 and 1987.

Capacity of the System to Handle the Problem

- o The System does appear to have sufficient earned surplus and earnings in spite of the bad assets to enable it to absorb those assets without jeopardizing stock held by borrowers.
- o The System's assessment of its ability to absorb losses is far too conservative because they: (1) believe FCS needs low leverage to borrow (8:1), where in fact "agency" borrowers borrow effectively with much higher leverage (70:1); (2) only grudgingly tap the surplus of System banks (\$4.1 billion at year-end 1984) and resist tapping the surplus of System associations (\$2.1 billion at year-end 1984) (there also were loan loss reserves of \$1.3 billion); (3) believe competition will force them to compress the net interest margin considerably below 1985 levels, which are low by historical standards; and (4) fear the flight of good borrowers (with their borrower stock, which FCS is reluctant to tap anyway).
- o If bond market investors believe FCS has lost the "implied" backing of Government, FCS is correct to fear an adverse market reaction to its losses and erosion of capital. But if bond market investors receive sufficient assurance and permit FCS to roll over its debt, total FCS (banks and associations) surpluses and loss reserves should provide a sufficient cushion. Even if agricultural conditions worsen beyond FCS's projections, it should take another year or two to work through FCS's total surplus.
- o FCS fears about competition and borrower flight have some validity, but not enough to require Federal funds now. Many FCS competitors are also ailing. As an "agency" borrower, an efficient FCS should be able to compete. Furthermore, the number of FCS borrowers who can pay off their loans or find an alternative source of credit for land loans (about \$50 billion of FCS's portfolio) is probably limited in today's market environment.
- o The current surplus should also enable the System to continue operating as a viable lender, with the possibility of its returning to a break even or minimally profitable operation

in 1988. Using basically FCA and FCA's own estimates for 1985-87 and a simple extrapolation to 1988 produces the following selected financial statistics for the consolidation of the 37 banks and all local associations:

	(\$ Millions)				
	<u>1984</u>	<u>1985</u>	<u>1986</u>	<u>1987</u>	<u>1988</u>
Net Income	373	(2,800)	(1,348)	(1,412)	small but positive
Surplus	6,200	3,400	2,100	700	700+
Total Capital	11,800	8,700	7,000	5,100	5,100+
Loan Loss Reserves	1,300	3,300	3,000*	2,300*	*
Capital as a % of Assets	13.5%	10.6%	9.2%	7.8%	7.8%+

\* These numbers depend on the rate at which charge-offs are incurred to reflect foreclosures and restructurings. We used FCS's assumptions about holding non-earning assets, which do not envision an aggressive disposal process.

#### LEGISLATIVE PROGRAM

There appears to be substantial agreement between the Administration, the FCA, and FCS regarding improved use of the System's surplus and capital funds and broad major regulatory reforms.

Some areas of current potential disagreement remain, the most notable being the need for, and form of, Federal financial assistance. There are also details underlying major areas of agreement which must be resolved.

The broad principles for a legislative program recommended by the Economic Policy Council are as follows:

#### 1. Managing Surplus and Capital Accounts

The best mechanism for handling the System's bad asset problem is to permit the Farm Credit System's Capital Corporation (FCSCC), established under the FCS, to:

- a) acquire from the System loans and property at no greater than market value;
- b) assume obligations for consolidated FCS debt so as to carry the assets while they are being held, leased, or restructured in an orderly fashion;

- c) extract earned surplus from those operating units which have it and transfer it to those which are in deficit;
- d) assess the operating units sufficiently to capture their future earnings as support for FCSCC's debt service obligations and operating losses, subject to existing FCA regulations to transfer capital.

2. Reforms in Regulatory Authorities

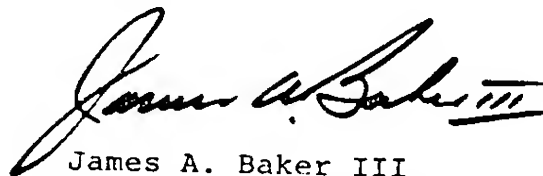
The best mechanism for ensuring a permanent solution to the System's operating problem is to provide a strong and effective regulatory agency with authority broadly similar to that regulating nonfarm financial institutions.

The reformed regulatory authority should be provided with general powers that include:

- a) restructuring of present management board with a single Chairman appointed by the President;
- b) general rulemaking authority and examination and enforcement powers;
- c) power over exit and entry to the system, including approval and/or requiring mergers;
- d) authority to establish capital requirements and safety and soundness provisions.

ASSESSING THE NEED FOR FEDERAL ASSISTANCE

The Department of Agriculture, in its testimony, has emphasized that the Administration will assess the need for Federal financial assistance, but only if Congress is willing to legislate the changes that will restructure the FCA and strengthen the FCS and the FCSCC.



James A. Baker III  
Chairman Pro Tempore